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Report Highlights:

As the scale of E-Commerce in China continues on its forecasted track to surpass the United States by 2015, a world wide web of opportunity has presented itself to the world amid burgeoning incomes, growing demand, and a tremendous market reach. China’s online retail market consists of a vast ecosystem of E-Commerce platform giants, logistics solutions and setbacks, and a new set of market forces. As online retail growth far outpaces offline growth in a country with only 40% internet penetration, serious firms must move to capture a foothold before digital saturation occurs. This report gives a survey of important aspects of E-Commerce in China and details the tools and strategies available for U.S. Companies looking to enter the virtual frontier of food and beverage marketing in China. This report will be the first of a series of reports highlighting eCommerce options for various food and beverage sectors and will include highlights of recent eCommerce promotion programs with T-Mall.com and WoMai.com

General Information:

China: An Online Frontier

Since the humble 1999 inception of Chinese e-commerce, China's internet infrastructure and commercial activity have experienced viral growth. According to a recent McKinsey report, that growth has rapidly accelerated over the last 5 years, allowing for the industry's size to double annually and average 120% compounded annual growth since 2003.This year, China is expected to surpass total U.S. retail e-commerce sales by 15% and become the largest online retail market in the world. By 2015, analysts estimate that China's e-commerce market will be 20% larger than its U.S. counterpart with total sales reaching $420 billion.

Rising online sales should not be viewed as a 1:1 replacement of brick-and-mortar business models and distribution channels; rather, they have spawned a net total growth in overall commerce. Despite a slight slowing of the growth rate of internet users which currently number around 564 million, the execution of online shopping has continued to experience rapid growth and outperformed 2011 by 24% to bring the total number of online shoppers to 242 million. This indicates that e-commerce as a market access platform is striving to meet a growing demand for goods that is outpacing the market's current logistical supply. With broadband penetration at a mere 30% and rapidly increasing internet access from mobile devices, China's e-Commerce holds a tremendous amount of future growth potential.

As China's e-commerce market continues to grow at a rate three times that of the offline retail market, domestic and foreign businesses must develop strategies for the distribution and sale of their goods online in order to protect their market positions. A well-executed online retail presence provides multi-channel operations the ability to better connect with the vast network of internet using consumers, synergize multiple distribution modes, and increase the viability of reaching lower tier cities.

Food and Beverage goods hold great potential for foreign importers given Chinese anxiety over food safety and regulation and positive perception of foreign goods with respect to quality. While food and beverage currently accounts for only a small percentage of online retail sales, its share of the e-commerce market has steadily gained strong momentum over the last five years and has become the second fastest growing food and beverage market of all major Asian countries. Groceries are quickly becoming one of the top purchased online goods with e-Commerce merchants allocating high-priority web space to the category next to electronics and apparel. This rapidly expanding category has increased competition and accelerated the development of logistical infrastructure.

Behind the Growth of E-Commerce

1. **Rising Income and Consumption Rates**

Increasing disposable incomes are fueling excess consumption and online sales. China's dominant rate of e-commerce growth is a result of several changes in Chinese society over the last decade that have increased consumer spending and consumer access to market goods. Central to the widespread growth in any nation's retail market is a healthy amount of disposable income. The massive surge in e-commerce spending can largely be attributed to the rise of China's urban middle class. In 2000, only 4% of urban households were considered middle class; by 2012, that figure roared to nearly 70%.

Though China experiences a large range of income levels varying by geographic region, its annual disposable income per capita has quadrupled from $760 in 2000, to $3000 in 2010. Please keep in mind that the majority of the Chinese population still lives in rural areas and earn very low incomes compared to urban dwellers. There is also a rapid rate of urbanization taking place which has also spurred domestic consumption and economic growth in China.

E-Commerce has strengthened Chinese consumer purchasing power. The economic efficiency and greater cost-effectiveness of online retail platforms versus their brick-and-mortar counterparts have resulted in lower prices for Chinese consumer. A Kantar Retail pricing study found that online purchases held an average 4% price advantage over offline purchases. Among product sub-classifications, online edible groceries held the strongest price gap with an 8% advantage while immediate consumables held a slight price disadvantage. Foreign food and beverage exporters should take careful note of the average 9% price advantage online imported food outlets hold over offline stores. Some E-Commerce companies have indicated to us that as a rule of thumb they will not discount goods more than 10% lower than traditional retailers. However, some purchase products directly and exert control over sales and pricing, while others sell on a commission basis and allow the seller to retain larger controls. This difference in pricing structure is a double-edged sword with the potential to either yield higher sales and profits or result in painful losses of margin and brand control. An effective strategy for managing this balance is discussed in the "Strategic Concerns" section of this report.

2. **Growing Consumer Base**

Expansion of Internet Infrastructure will sustain growth rate of "e-tail". While greater purchasing powers in China have provided the financial fuel for the huge growth in e-commerce, the expansion of China's internet infrastructure has physically enabled greater consumer access to market. Despite the rise in disposable income and the subsequent rise in demand, China's conventional retail industry has been unable to develop at the same rate. E-Commerce has experienced such a surge of growth precisely because it has been able to target and meet growing unmet consumer demand. This has been especially true in lower tier cities where modern retail infrastructure is still in its infancy. Additionally, the breadth of the manufacturing industry has facilitated the sourcing of a diverse body of goods. This variety of selection is essential to generating consumer activity. China now leads the world in internet usage with 564 million internet users at the end of 2012. This yields a 42.1% internet penetration rate in China- more than double the rate recorded in 2007 from studies done by Analysys International. By contrast, the United States is a much more internet saturated nation with broadband internet penetration rates over 90%. According to China Internet Network Information Center (CINIC). The bulk of China's internet infrastructural growth has come as a result of the proliferation of mobile devices. The number of users accessing the internet through mobile devices hit 422 million by the end of 2012 and now accounts for 75% of internet usage. Though internet usage via computers has dropped slightly, the massive uptick in mobile devices resulted in a net gain of 51 million new internet users for 2012.

Reinforcement of provisional e-Commerce services is necessary to support future growth. A 2012 Bain analysis report cites secure online payment methods, reliable delivery services, government standardization of online platforms, and increasing consumer familiarity as key factors in the maturation of e-Commerce in China. In order to capture new online consumers and inspire confidence and loyalty to the e-Commerce framework, businesses and developers have risen to cultivate these infrastructural attributes.

Continued development of trusted transaction mechanisms will facilitate spending. AliPay, AliBaba Group's third-party online platform, provides the key backbone for online payment and handles over 50% of China's online transactions with integrated solutions on the web domains of China's biggest E-Commerce giants. Last year, Taobao and Tmall processed $170 billion in transactions, which was greater than that of eBay and Amazon combined, according to a recent report by Morgan Stanley. As an escrow service, AliPay verifies the consumer's satisfaction with a purchase before transferring payment to the merchant. Such a payment intermediary platform mechanism serves as a critical reinforcement of consumer online confidence in a country where weak consumer protection laws have yet to catch up with the burgeoning market. Most Chinese consumers do not use credit cards; those that do are still reluctant to use them for online transactions due to fraud concerns. AliPay has moved to fill this confidence gap. Many E-tailers also allow for cash-on-delivery services which meets the needs of those without credit cards.

Logistical shortcomings limit expansion of market reach to potential consumers. This is of particular relevance to the food and beverage industry which relies upon cold-chain distribution networks to deliver fresh products and frozen goods. Food and beverage sites are currently limited to delivering within urban hubs- massive delivery to lower tier cities (with the exception of FruitDay.com's cherries from a recent USDA/T-Mall promotion) remains difficult.

3. Mobile Devices and Shopping

Mobile devices unlock huge untapped growth potential. When examining the growth of e-commerce and developing future strategies, it's important to understand how mobile devices are influencing the nature of online retail in China. Mobile devices as a mode of internet access are unique in that they do not depend upon wired infrastructure and thus are able to facilitate the expansion of internet access beyond urban hubs. Until 2009, rural internet penetration in China hovered well below 10%; that figure has since reached 27.6% (2010, CNNIC). The impact of the mobile device on rural internet access is evidenced by the greater percentage usage of mobile devices in rural areas versus that of urban areas. While the internet growth rate has slowed slightly since 2012, there is strong reason to believe that significant growth will come from current offline citizens due to the high liquidity of current non-internet users in China as human internet assets. Current non-internet users with no intention of transitioning into the online world indicate age and technological ignorance as barriers to leaving the offline world. These inhibitors, however, can be alleviated in the near future through software application innovation with an emphasis on intuitiveness and ease-of-use. Additionally, with 79% of Chinese internet users between the ages of 10 and 40, age as an inhibiting factor should eventually be phased out. This isolates convenient physical access as the primary reason for would-be users refraining from accessing the internet. The combined proliferation of mobile devices and expansion of cellular networks will tap into these would-be users and extend market access. With over 50% of China's population untapped by the internet, the e-commerce market should continue to maintain its huge growth potential to which the development of mobile software and application platforms will be integral.

Mobile device apps increase number of shoppers and amount of spending. With the improvement of mobile internet infrastructure and rampant popularity of smartphones, 2012 saw the wide-spread development of e-commerce mobile applications. Access to these applications have allowed Chinese mobile internet users to access a multitude of services and functions including online payment, online banking, online shopping, and online group shopping. In January 2013, AliPay announced the re-launch of its digital wallet app for Android OS which provides a mobile solution for online-to-offline payments. AliPay reported a 223% growth in its wireless payment users through 2012 with over 350 million of its 700 million registered accounts being conducted from mobile devices. With the high volume of online transactions being conducted through the platform, AliPay is quickly becoming an important player in China's banking industry by providing millions of consumers with basic financial services that did not exist just a few years ago.

Mobile e-Commerce is more accessible and scalable vs. conventional retail. Executing purchases and other online transactions over mobile devices poses several advantages to the consumer. Firstly, mobile internet shopping removes the physical limitations of conventional shopping and allows for transactions to be completed conveniently. Secondly, access to high demand desirables such as clothes, cosmetics, travel bookings, and tickets is more readily supplied. Lastly, mobile shopping applications have empowered the consumer, allowing for a more engaged shopping experience with little additional effort. The development of consumer information applications such as bar code readers have allowed for more powerful comparison shopping while social media integration has fostered a freer exchange of real-time information amongst consumers and thus created a more cohesive consumption body. These innovations on mobile device platforms have greatly multiplied the impact mobile device proliferation has held for the growth of e-Commerce in China. Businesses that are able to cater to this technological demographic will be able to take advantage of this frontier. Strategies for developing a presence in the world of mobile devices are discussed later in this report under "Strategic Concerns".

Structure of E-Commerce

China's e-Commerce is largely comprised of pure online operations. Approximately 90% of electronic retail in China occurs on dedicated e-commerce platforms dominated by Consumer-to-Consumer (C2C) sites like Taobao.com and followed by Business-to-Consumer (B2C) giants such as T-Mall.com and YiHaoDian.com, according to McKinsey's report. As susidiaries of Alibaba Grp., founded by Jack Ma in 1998, Taobao and T-Mall enjoy a hefty market share. Taobao is very similar to America's eBay and T-Mall is a rough equivalent to Amazon. Yihaodian was founded as one of China's first online supermarkets by former Dell/Amazon employees in 2008. It was acquired by Wal-Mart in 2012.

These online marketplaces serve as central hubs for manufacturers, retailers, and individuals to conduct sales of products and services to consumers. China's e-commerce model stands in stark contrast to the United States model centered on either giant brick-and-mortar operations like Wal-Mart and Safeway, or online merchants who govern the entire distribution process from the placed order to the consumer's front doorstep. Such a developed market is primarily comprised of large-scale specialized retail chains with e-commerce sectors. Currently, independent merchants account for only 10% of electronic retail in China. In addition to the bulk of sales and distribution being conducted through large online intermediaries, there is a growing body of third-party service providers that work with merchants to handle social-media/marketing, web-design, transaction fulfillment, logistics, and customer service. Despite the relative youth of E-Commerce in China, average online earnings edge out those of average brick-and-mortar operations with margins of roughly 8-10%, based on McKinsey's estimates.

Online groceries are the fastest growing e-Commerce good. Online grocery sales are currently experiencing compounded annual growth rates of 65% (Mckinsey eCommerceTrends) which far outpace its 9% CAGR as a share of China's total retail value. This indicates that the food and beverage E-Commerce industry is capturing both potential market share and current market share from brick-and-mortar operations. This makes sense given that nearly 80% of all food in China is sold through traditional wet markets lacking in sufficient cold chain resources and modern hygiene standards. Meanwhile, Western countries are saturated with modern supermarket retail infrastructure. The emergence of new online shopping habits may drive the future of modern supermarket systems and cold chain infrastructure in China.

Efficient, reliable logistical frameworks are future-critical, especially for food and beverage providers. The elusive nature of coherent distribution systems in China is the bane of online commerce whose secondary good is product delivery. Logistical infrastructure in China is fragmented and plagued by inefficiency- an issue which is exacerbated outside of the developed coastal region. China's logistics costs consume 18.1% of GDP while the United States spends just 9.5% on the same, according to studies from McKinsey.

As the number of online shoppers has continued to expand, speed and reliability of delivery have become a very significant online consumer demand. YiHaoDian, of which Wal-Mart is a majority shareholder, is a popular up-and-coming online grocer that has pursued aggressive investments in logistics in order to ensure competitive prices and cheap, reliable delivery. While attractive pricing has long been a top driver of online consumption, the expansive reach of online information has made this a given for any successful e-tail. The determining variable for consumer loyalties has quickly become the quality and performance of deliver systems. Of particular consequence to the online grocery sector are the obstacles faced when developing dependable cold-chain logistics. Currently, online grocers are limited by the range at which adequately performing cold-chains can be operated. This constrains the majority of food & beverage e-Commerce to localized urban markets. Frozen foods are an area where brick-and-mortar markets continue to outperform online distribution given the cold storage facilities available to a static store.

As a consequence of the number of times a product changes hands during distribution, the utilization of a patchwork of logistics companies degrades a product's quality assurance prior to and after delivery.

This is especially true for food and beverage operations which face unreliable climate control during third party operations.

1. Distribution Models

The standard acceptable time from point-of-order to final delivery is around four days. In order to achieve this timeline, three unique logistics models have arisen: third-party, self-run, and joint distribution.

Third-Party logistics describes operations where the business entity entrusts the delivery of products to an external logistics company. This model better suits small or less-established businesses as it achieves the use of extensive, advanced logistics operations without large framework investment costs. While the separation between the two enterprises allows each to focus efforts on a smaller range of responsibilities, it poses a potential control issue to the root business. The success of this model is dependent upon an effective business relationship between the working entities. The low capital cost of the third party logistics model makes it widely used amongst B2C platforms.

Self-Run logistics refers to the control and operation of a business' very own internal logistics system. For larger operations, this would include the construction and development of storage centers and distribution points. The integrated nature of this model yields a high degree of systemization and efficiency of distribution. The self-run logistics model also provides a business the most consumer contact and engagement, allowing for real-time adjustments to be made based on direct feedback. This dynamic system allows for a firm to be both flexible and efficient. These benefits are not without costs: initial investment costs are high and do not make sense for smaller localized firms given diseconomies of scale and large operational costs. This logistics model is best suited for broader business operations with the high volume of product and sales and large margins to warrant wide regional distribution channels.

The ***Joint Distribution*** model refers to the collaboration and coordination of logistics companies working to deliver under a unified scheme and system of synched distribution centers in order to capture efficiency. The logistics system is seen in large Chinese enterprises with multiple large-scale departments such as Suning.com. While this model reduces distribution costs and better reflects economies of scale, it is susceptible to conflicts and misinformation across different philosophies, regulations, and corporate culture. In the case of Suning, competition between online sales and regional sales has bred half-hearted distribution efforts and thus poor service. Consequently, Suning posts the longest distribution cycle (10-15 days) and a low satisfaction rating.

Companies that are looking to enter the E-Commerce market can exercise greater control over the distribution process either by utilizing the services of end-to-end logistics companies or partnering with large platform sites, such as T-Mall and TaoBao, who have already developed cohesive, trusted distribution channels. In a partnership with T-Mall, Fruitday.com is currently distributing 50,000 orders of Northwest cherries nationwide after a highly successful weeklong promotion. This is Fruitday's first nationwide E-Commerce distribution in China and the largest effort thus far, targeting 15 cities in China. The logistical support of T-Mall has enabled FruitDay to maintain cold temperatures for the delivery of these highly perishable cherries, albeit with higher packaging costs. Please see GAIN Report for further details about this activity.

2. **C2C vs. B2C**

C2C e-Commerce continues to dominate online retail but B2C platforms have experienced increased growth.C2C platform Taobao.com currently commands the majority of e-commerce in China and posted $85 billion in 2011 revenues, making it the largest online shopping portal in the country. According to iResearch, B2C platforms remain relatively immature with an approximate 10% share of online sales. Despite a humble start, B2C sites are experiencing tremendous growth as pure online platforms and traditional retail giants such as Wal-Mart are moving to take advantage of the opportunity, based on studies from Bain. B2C platforms, such as T-Mall, afford E-Commerce businesses centralized promotion and a well-maintained web-space that a C2C aggregate such as TaoBao cannot.

Consumer trust and loyalty have been integral in the growth of B2C. C2C sites like TaoBao do not need to actively pursue new consumers and the retention of old ones given that their supply of a functional and popular forum with a strong user base is in of itself conducive to garnering new users. In other words, new and returning C2C users utilize TaoBao simply because that is where the majority of consumers selling to others are.

3. **Platform Aggregates vs. Product Specific**

Platform aggregates offer greater consumer exposure and logistical resources at a cost to business control. Platform aggregates excel at receiving a large base of web traffic given their conduciveness to search engine results and market comprehension that they hold by consolidating goods across the board into one platform. However, because T-Mall's success is heavily tied to its reputation, it exercises greater control over the businesses and the goods it features. Promotions, scope of logistics, and associated business practices are all under the indirect authority of the platform aggregate host.

Well-established businesses in the China market seeking to transition into the online realm may find that high-powered platform aggregates are not the best fit. On the other hand, un-established businesses that are new to China's online retail market may find platform aggregates as a more secure way to jump into E-Commerce.

Strategic Concerns

1. **Insulating Product From Negative Online Influence**

The offline market is an online price-taker. The internet is for all intents and purposes a non-physical entity. As such, E-Commerce ties all goods nationwide into one market. Any good that is put onto the online market will introduce a new price point into the retail market of the entire nation. In an economic environment where consumers have tremendous product data and are driven by product value, any newly introduced price point affects all similar goods. Hybrid businesses balancing both offline and online channels must exercise caution when listing products online at competitive pricing as all of that businesses' goods, whether offline or online, will take this new price point. In other words, online sales bring greater transparency which must be considered when developing strategies for the China market.

In order to combat loss of brand and margin control, we strongly recommend diversifying product lines throughout different distribution channels to market as an effective strategy to manage the balance between offline and online sales. Do not disperse a given product line across both online and offline channels unless you are able to exercise basic pricing and brand controls.

2. Resale or Consignment

Resale mechanisms secure earlier liquidation of product at a cost to control. Tread carefully when working with popular platform sites that purchase products from companies for resale. While this may alleviate the anxiety from companies concerned that a product may not sell well in the marketplace, a new concern arises: margin and brand control. Selling goods with resale rights to E-Commerce platforms relinquishes price control, which may result in other products taking an unintended price cut. A common practice for some resale E-Commerce platforms is to sell some goods at a loss as a means of attracting customers into the platform and thereby boost the sale of other goods. While this tactic may result in increased sales and profits for the online platform, it can be damaging to the company whose good is being utilized as a loss-leader. The company is then faced with the choice of either surrendering the same good being distributed in other channels to the lower price point or risk facing cannibalization from the resale good.

3. Defending Market Position

Leverage quality assurance to compete with domestic food and beverage products. Growing health concerns and food safety setbacks in China have fostered a deeply cautious and anxious perception of the domestic food and beverage market. There is a strong preference for imported food and beverage staples amongst middle and upper class Chinese. Notable goods include dairy products, infant formula, meat, fruits, fruit juice, wine, and basic cooking ingredients. The primary reasons for this preference are the perceived higher quality, authenticity, and safety of imports, as well as perceived cultural value in the case of luxury goods such as wine and Apple computer products. In many cases, the positive Chinese perception of foreign imports and their cultural value is so strong that an inferior import product may still be regarded as high-quality. This has been especially true in the wine industry where French wine is dominant with over 60% market share, according to Euromonitor. Despite accusations that French wine exporters are re-labeling cheap products as high-end goods, France has continued to dominate the market because of their cultural and long-term marketing efforts- something U.S. wine exporters have not emphasized.

Use Chinese public perception of imported goods to your advantage. Exporters to China should take advantage of the positive perception Chinese consumers have of foreign imports. Products should retain as much of their foreign aura when presenting them in the market. In addition to doing the same in other marketing mediums, retaining Western labeling and utilizing non-Chinese language and imagery serves to make a better impression on the Chinese consumer. While it may seem counter-intuitive to achieve better commercial success in China by refraining from adapting to Chinese labeling and branding practices, doing so helps to clearly brand a product as imported and consequently- in the consumer's mind- of high quality. Last year, a U.S. dairy trader rebranded and relabeled an American milk product for sale in China. The product featured all Chinese labeling and reduced the only English reference to America to a small “Made in the USA” placed discreetly in the corner of packaging. Encountering consumer inquiries concerning the origin of the product, the company was forced to repackage with bilingual labeling to avoid consumers’ confusion. Despite the demonstrably higher quality and safety of the product, the marketing strategy for the good associated itself too closely with the domestic market and biased the consumer against it. Sales of that product have surged since the company switched to English labeling.

Additionally, U.S. food and beverage exporters should utilize simple English catch phrases highlighting the quality and natural aspects of their products. While paying attention to stricter nutritional health claim limitations implemented by the Chinese government on all food and beverage products sold in the China market, marketing campaigns should also prominently feature seals of approval and certification awards from American agencies. These labeling elements serve as effective endorsements in China where it more greatly boosts the consumer’s positive perspective than in the United States where they are viewed as regulatory requisites.

4. Improved Services and Consumer Engagement

Superior services are critical. As a value-driven industry, E-Commerce has accelerated the “race to the bottom” as far as pricing structures and transparency are concerned. The virtually instantaneous nature of the internet and availability of a multitude of free powerful comparative tools for consumers make competitive prices and value a basic requisite for an online presence. While the lower barrier-to-entry of E-Commerce allows for businesses to flourish with less capital costs, the saturation of China by online retailers has led to stiffer competition where the differentiation of products and pricing become more difficult. After initial price wars, businesses must focus on customer loyalty through superior service in order to retain E-Commerce consumers. Promoting quality assurance on deliveries and executing generous return policies are proven strategies to meet rising consumer expectations and gain a competitive edge, McKinsey suggests.

Social-media marketing is essential for driving online activity to your business. E-Commerce strategies should be developed in the future to include social media and word-of-mouth promotion campaigns through the assistance of well-known and respected bloggers across China. The capital cost for these more targeted campaigns can be lower than traditional advertising programs, but there are fewer companies with this kind of experience and thus require more direct communication with consumers.

Conclusion:

ATO Shanghai sees eCommerce as a major new channel for U.S. Companies wishing to both test the China market and to expand their sales to new buyers across China who may not have access to brick and mortar retail shops that specialize in high value, imported food and beverage products. ATO Shanghai launched it's first major online promotion with Yihaodian in December 2011. In December 2012, we launched our first pre-sale promotion with T-Mall. An even larger, nationwide promotion was launched at the end of June 2013 which included 60 skus and sales made to buyers in 40 cities across China. Fruitday.com, a major fruit etailer, sold more than 50,000 orders of US Northwest Cherries during the 10 day promotion. We also launched a similar program with even more US food and beverage skus with COFCO's WoMai.com. Since most of these etailers are just starting to get into food sales, they have been very eager to work with our office and find more and more imported food and beverage products for their online platforms. These products include all sorts of products from live lobsters, to frozen pork, to cases of UHT milk. If your company is serious about the China market, make sure to make eCommerce a major part of your market development strategy and feel free to contact ATO Shanghai for more information.